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No. 16815

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

CATHERINE C. STARK,

Appellant,

vs.

ARTHUR S. FLEMMING, SECRETARY OF THE DEPARTMENT OF HEALTH, EDUCATION AND WELFARE OF THE UNITED STATES,

Respondent.

APPELLANT'S BRIEF

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I. STATEMENT OF JURISDICTION

The jurisdiction of the District Court rests upon a statutory review of a final decision of the Secretary of the Department of Health, Education and Welfare of the United States which denied appellant's claim for old-age insurance benefits. Appellant invoked this jurisdiction by filing her complaint for review of this decision within the time allowed by law.

> (Tr. 1) Sec. 205(g) of the Act of Congress of August 14, 1953 as amended, 49 Stat. 624, 42 U.S.C.A. Sec. 405(g).

Summary judgment was entered against the appellant in the United States District Court for the Northern District of California, Southern Division, in proceeding No. Civil 38250 on December 8, 1959. The jurisdiction of this Court is conferred by a statutory provision that the courts of appeal shall have jurisdiction of appeals from all final decisions of the District Courts of the United States.

> (Tr. 17) Sec. 12(e) of the Act of Congress of July 7, 1958, as amended, Public Law 8-508, 72 Stat. 348, 28 U.S.C.A. Sec. 1291.

II. STATEMENT OF THE CASE

Appellant instituted this action in the District Court for a statutory review of a final decision of the Secretary of the Department of Health, Education and Welfare denying her claim for old-age benefits. The Secretary's denial was based on the ground that appellant had received no wages within the meaning of the Social Security Act, because the corporation by which she was employed was a sham whose entity should be disregarded and that therefore the compensation she received was rental income which did not constitute wages under the Act. The District Court concluded that the findings of the Secretary were supported by substantial evidence. Appellant asserts that there is no direct evidence to support the findings that the corporate entity should be disregarded and none from which such an inference can be drawn and, furthermore, that in any event, she rendered services which would be covered by the Act.

III. SPECIFICATION OF ERRORS

The appellant specifies the following errors as having been committed by the District Court:

A. The Court erred by concluding that the findings of the Secretary were supported by substantial evidence.

B. The Court erred by concluding that said findings were supported by inference that could properly be drawn from the evidence.

C. The Court erred by concluding that appellant's services were minimal in extent.

D. The Court erred by concluding that appellant's salary was disproportionate to the services she rendered.

E. The Court erred by concluding that no plausible reason existed for the incorporation.

F. The Court erred by concluding that the Secretary could disregard the corporate entity.

G. The Court erred by concluding that appellant was not entitled to benefits under the Social Security Act.

H. The Court erred by entering summary judgment for the defendant.

IV. THERE IS NO SUBSTANTIAL EVIDENCE TO SUPPORT THE SECRETARY'S DECISION THAT THE CORPORATE ENTITY SHOULD BE DISREGARDED.

A. Summary of Argument.

This case involves a decision of the District Court granting appellee's motion for summary judgment and denying appellant's motion for summary judgment based on the pleadings and the Referee's Transcript. The District Court proceeding was an appeal from the Referee's decision which had been adopted as the final decision of the Secretary of the Department of Health, Education and Welfare. The entire Transcript is before this Court. The evidence contains nothing which will support the finding that the subject corporation was a sham and that its entity may be disregarded. Any inference drawn from the evidence to that effect is without substantial basis and is therefore unwarranted and unreasonable.

B. Summary of the Facts.

Prior to her husband's death appellant and her husband had owned a farm in North Dakota for many years. (Tr. 37.) In addition, appellant had assets of her own consisting of a duplex in Oakland, California, and a certain amount of cash. (Tr. 82, 83, 100.) The appellant and her husband had the custom of spending their summers in North Dakota and their winters in California. On January 27, 1956, the husband died in Oakland, California. (Tr. 36.) Shortly after her husband's death appellant discussed with her son, Frank-

lin C. Stark, the desirability of having him assist her in policy-making decisions in connection with the farm and city properties. He agreed to do so if a corporation were formed to give them limited liability. It is to be noted that both of them had assets other than what was put into the corporation. (Tr. 40-41, 83.) After the corporation was formed the appellant transferred to it all of the assets of her husband's estate and in addition, the duplex which she owned in Oakland. These assets exceeded in value the sum of $36,000. (Original File v. 2, p. 117.) She was appointed general manager at a salary of $400.00 per month. (Tr. 43, 66.) She performed numerous duties for the corporation and was the only person during the period of time involved in active management. The services Mrs. Stark rendered were extensive. The record indicates that her duties as president and general manager called for a full time job and that she averaged in excess of 40 hours per week. (Original File v. 2, 103.) The various transcript references to Mrs. Stark's duties are referred to in Appendix "A" and will not be repeated here. However, because of the importance of the question, the type of duties she discharged will be reviewed. She received and disbursed all funds of the corporation, maintained the corporate records and prepared the payroll tax returns. In connection with the farm she obtained storage facilities for the crops, arranged for repairs and maintenance, negotiated a crop-lease, discussed with the tenant and other people the type of crops to be planted under the crop-lease, made attempts to sell the farm so that the money could

be invested in more productive property, sold personal property on the farm, reviewed various data on soil conservation and determined the correct crops to be planted, supervised lessee in carrying out the crop-lease, paid the taxes and insurance and arranged for the disposition of her share under the crop-lease. In connection with the duplex she not only collected the rent and made necessary payments on the loan, but arranged for repairs which were required and obtained a new tenant when a vacancy occurred.

The extent of her services can best be obtained by reading the excerpts from the minutes of the meetings of the Board of Directors which appear on pages 120 through 124 of Volume 2 of the Original File. The various services reported show that they were extensive and completely in keeping with the intent of Congress under the Social Security Act.

Appellant continued in active management until she became ill and was forced to retire on her doctor's orders. (Tr. 59, 100-101, 103, 104.) (Original File V. 2, p. 110, 111, 114, 115.)

C. There Is No Evidence to Permit Disregard of the Corporate Entity.

The District Court found that the inference drawn by the Secretary that the corporate entity should be disregarded was supported by the evidence. (Tr. 11-16.) The Secretary's decision is, of course, based on the Referee's decision contained in the Transcript at

pages 22 through 32. Merely putting a label on a set of circumstances does not solve the problem, and in this case calling the corporation a sham cannot eliminate a careful review of the evidence. Such a review shows that there is no evidence whatsoever which can support a finding that the subject corporation was a sham. The most that can be said for the Referee's decision (and this was the position taken by the District Court) is that an inference to that effect can be drawn from the evidence. However, such an inference can only be drawn if supported by all the evidence and it is improper to choose a few unfavorable points and disregard the favorable ones.

In *Goldman* v. *Folsom* (C.A. 3rd, 1957), 246 F. (2d) 776, the court held that the decision by the Referee subsequently adopted by the Secretary was not supported by substantial evidence. A Referee cannot pick out some evidence and ignore other evidence but must consider the case as a whole. Thus the Court stated at page 779 as follows:

> "The referee while noting the testimony and affidavits of the claimant's five fellow-employees as to her employment chose to ignore them as part of the evidential scene despite their disinterested character.
>
> "He ignored too, the testimony of the claimant's physician that she was mentally incompetent at the time she gave Brobyn the June 25, 1954 statement and chose instead to accept the

> 'opinion' of mental competency of a layman, Brobyn, who had spent only 45 minutes with the claimant on that date and who had only observed her for an hour or so four months earlier.
>
> "The referee also chose to accept the hearsay testimony of Brobyn that Florence Polk who had witnessed the June 25th statement had stated at the time that she 'knew' the contents of the statement to be true despite the fact that Mrs. Polk testified that she was not present at the time the statement was given, that she was not aware of its contents and most significantly that she had not been employed by the claimant and did not know her during the 1951-53 claimant-employment period. Moreover, the referee on the score of mental competency, failed to note Mrs. Polk's testimony that the claimant didn't seem to know what she was doing at times in June, 1954 and 'she didn't know too much about her affairs'; 'her memory was very well' and 'her condition gradually got worse.' "

Where a Referee expressed an opinion on the physical condition of a claimant the Court in *Jacobson* v. *Folsom* (S.D. N.Y. 1957), 158 F. Supp. 281, stated at page 285:

> "Such a lay observation as was made by the Referee can only have been based on surmise and speculation and is certainly of insufficient probative value to derogate from plaintiff's testimony supported by medical records."

Thus we can see, as these authorities indicate, that the entire record should be reviewed by the Court and if the Secretary has drawn inferences which are unwarranted and unreasonable when related to the entire record, then his decision must be reversed. See also *MacPherson* v. *Ewing* (N.D. Cal. S.D., 1952), 107 F. Supp. 666, *Fuller* v. *Folsom* (W.D. Ark. 1957), 155 F. Supp. 348, and *Miller* v. *Burger* (C.A. 9th, 1947), 161 F. (2d) 992.

The term "wages" is defined in Section 209 of the Social Security Act (42 U.S.C.A. 409), in terms of remuneration paid for "employment." Section 210(a) of the Act (42 U.S.C.A. 410[a]), defines the term "employment," so far as pertinent here, as "any service, of whatever nature, performed after 1950 . . . by an employee for the person employing him . . ." The term "employee" is defined in Section 210(k) of the Act (42 U.S.C.A. 410[k]), as meaning:

> "(1) any officer of a corporation; or
>
> "(2) any individual who, under the usual common-law rules applicable in determining the employer-employee relationship, has the status of an employee; . . ."

The Referee's attempt to justify his disregard of the corporate entity is based on the four following assertions:

1. That the services were worth little or nothing. (Tr. 29.)

2. Rental income was incorporated, thus, turning non-social security income into social security income. (Tr. 30.)

3. The corporation lost money. (Tr. 30.)

4. The corporation was formed to take advantage of the Social Security Act. (Tr. 29-30.)

Of course, it has been established that no one of these factors, taken by itself, could permit a disregard of the corporate entity except possibly the first one. Thus, it has been clearly established that any person has a legal right to pursue his business in the corporate form, and there is nothing to prevent a corporation from engaging in a rental business if it so desires, nor is there anything wrong in a person setting up his business in such a way as to qualify for social security benefits.

In *Rafal* v. *Flemming* (E.D. Va., 1959), 171 F. Supp. 490, a father sold his business to his sons and the purchase price was to be paid in installments over a period of time. After the sale he discovered that he was not qualified for social security but that he could be qualified if he were to go into partnership with his sons. Accordingly, he re-entered the business which he had sold to his sons as a partner under an agreement by which the profits paid to him were credited to the purchase price. In determining that the plaintiff was entitled to social security benefits the court said at p. 492:

> "It is considered by all parties that there is nothing improper or questionable about a person entering bona fide employment for the express purpose of acquiring a wage record which will enable him to qualify for old-age insurance benefits, and that such action is clearly within the spirit, as well as the letter, of the law."

As noted above, the Referee refers to the motive of the plaintiff in incorporating. However, in addition to the *Rafal* case cited above, the court in *MacPherson* v. *Ewing*, *supra*, 107 F. Supp. 666, at p. 667, states as follows:

> "To permit the Administrator to rest decision upon the *motives* of the employer or upon the *effectiveness* or *adequacy* of the employee's services or labor, absent any element of fraud or deceit, would be to entrust to him a power far beyond that statutorily conferred upon him."

The Referee also stresses the fact that the corporation lost money but, again, this factor does not permit him to disregard the corporate entity.

This is clearly demonstrated by a recent decision of this Court in *Flemming* v. *Lindgren* decided January 20, 1960 and reported at 275 F. (2d) 596. In that case the claimant had attained the age of 65 and then filed an application for Social Security benefits. He was told that he could not receive such benefits because his employment had been agricultural, to wit, raising

fryers on a three acre tract on the edge of Portland. He consulted his attorneys about arrangements necessary to obtain social security coverage and as a result a corporation was organized for the primary purpose of obtaining social security coverage for him. Lindgren transferred to the corporation his chickens, some cattle and four incubators. The initial assets of the corporation amounted to $2,500.00. The claimant was made President of the corporation and his wife Secretary and Treasurer. Although she worked in the business she received no salary for her services. The salary of the claimant as President was set at $300.00 per month, this amount being at the time the exact maximum creditable for social security purposes. Later on his salary was reduced to $75.00 per month to permit him to draw social security benefits. Then when the amount permissible was increased by law his salary was raised to $100.00 per month to conform to the increase. The Referee stated that the evidence clearly demonstrated that the business of the corporation was conducted in the same manner after incorporation as the claimant had conducted it before. The corporation operated at a loss and in order to meet its obligations, including claimant's salary, it was necessary for it to borrow money. This money came from the claimant who was issued promissory notes therefor. The real property which was owned by Lindgren and on which the fryer business was conducted was not transferred to the corporation. Nevertheless, no rent was ever paid for use of this land although his attorney testified that $50.00 per month was a reasonable rental

therefor. The tax returns failed to take into account any expense for rent and did not reflect the promissory notes.

The Referee denied Lindgren benefits, and this decision was sustained by the Secretary. The District Court determined that the Secretary's decision was arbitrary and capricious and entered judgment for the claimant. This Court failed to agree with the position taken by either the District Court or the Secretary and directed the District Court to send the matter back to the Secretary for re-determination. It recognized, however, that the mere fact that the corporation was losing money was insufficient to refuse benefits to the claimant, stating at page 597:

> "We realize that in his recommendations to the secretary the examiner came up with a handy rule . . . limit the salary to the amount of the earnings of the company, such being the amount that the corporation with negligible capital could sensibly afford to pay. Unless the corporation is held a complete sham and is entirely vitiated, in which case Lindgren would be back in his agricultural self-employed category ineligible for the benefits, we think that the secretary should have taken into account some other factors . . . because the test is, What is 'wages' under the act? He should reconstruct a reasonable wage under all of the circumstances. These might include past history of the same little business, wages of a laborer doing the same type of work as Lindgren, and perhaps a number of other

> factors will come to mind. Probably no one single factor should control.
>
> "It does appear that perhaps in the two years involved, economics were against Lindgren more than usually. The corporation did have a few assets. In the long run a corporation's earning record limits the salaries it can pay, but some pay more than they can afford for a while and then go out of business, or often they survive to become profit-making organizations. And persons nonetheless have had help in getting social security — all as a by-product of the over-payment.
>
> "We realize the scope of the review by the district court and by us is limited. But we do hold that an arbitrary standard was applied when no factor other than the exact actual earnings of the corporation was applied. Our decision still leaves the administrator of the act broad latitude for the exercise of his discretion."

In the *Lindgren* case the Secretary had relied on the case of *Gancher* v. *Hobby* (Conn., 1955) 145 F. Supp. 461.

The Government has relied on the *Gancher* case in denying the benefits in the present case. However, it should be observed that in the *Gancher* case no bona fide services were rendered to the corporation. There the claimant had transferred two vacant lots and a building in which his family resided and in which he had an office to qualify himself. There was only one

apartment occupied by an outsider. The Referee, in the *Gancher* case, stated that the picture of the claimant making rental payments to himself and then paying himself for services, approached the farcial. See the discussion of the *Gancher* case in *Rafal* v. *Flemming*, *supra*, 171 F. Supp. 490, at page 495. In our case the appellant did not occupy the real property which constituted the corporate assets. Both parcels were income producing property, one a farm, the other a duplex. Furthermore, the record will show that she did render substantial bona fide services.

Basically, the Referee just doesn't like the fact that it is possible to form a corporation and qualify. (Tr. 29-30.) However, the law permits this as the *Lindgren*, *Rafal* and *MacPherson* cases show and if there is to be any change in the law, it should come from Congress not from administrative interpretation.

There is no evidence whatsoever of fraud in this case. Nor is there any evidence that the corporation itself or the employment of appellant was a sham. The Referee states that the corporation had no bona file business purpose (Tr. 30) but he has no right to substitute his judgment for those of the parties involved. There are many factors besides qualifying for social security benefits that make a corporation desirable. As we have indicated earlier in this brief, the desire here was for limited liability. However, as we have stated, the motive was immaterial for it is perfectly proper to form a corporation to take advantage of social security benefits.

The Referee attempts to belittle the services of appellant. (Tr. 26-27.) He even goes so far as to state that they were not even worth $50.00 in any quarter. (Tr. 29.) The record is replete with evidence showing that the services of appellant were substantial. See transcript references in Appendix "A." They were reasonably worth $400.00 per month. In any event, they were certainly worth at least $50.00 per quarter. However, it is not for the Referee to define the exact value of these services so long as substantial services were rendered and this is clearly established by the record. The Referee also relied on the fact that the corporation lost money. Obviously, he would not disqualify all employees of businesses that are losing money. What he really objects to is the fact that he feels this corporation was set up to qualify the appellant. That this is permitted by law is clearly shown by the cases heretofore cited:

Flemming v. *Lindgren, supra*

Rafal v. *Flemming, supra*

MacPherson v. *Ewing, supra*

The Referee states that to uphold the corporate entity will permit an evasion of law. (Tr. 30.) He argues that rental income by itself does not qualify for social security and that one cannot evade this rule by incorporating rental income. (Tr. 31.) He overlooks the fact that extensive personal services were rendered as has been indicated several times. Refer-

ence to these services are contained in the Appendix. Furthermore, where services are rendered in connection with rental income, such income is included for social security purposes.

> *Thorbus* v. *Hobby* (S.D. Calif., 1954), 124 F. Supp. 868, affirmed in *Folsom* v. *Poteet* (C.A. 9th, 1956), 235 F. (2d) 937.

The applicable statutory provisions relating to rentals are as follows:

> "There shall be excluded rentals from real estate . . . (including such rentals paid in corp shares) . . . except that . . . this . . . shall not apply to any income derived by the owner . . . if (A) such income is derived under an arrangement, between the owner . . . and another individual, which provides that such other individual shall produce agricultural . . . commodities . . . on such land, and that there shall be material participation by the owner . . . in the production or the management of the production of such agricultural . . . commodities and (B) there is material participation by the owner . . . with respect to any such agricultural . . . commodity . . ." Act. of Congress of August 28, 1950, c. 809, Title I, Sec. 104(a), 64 Stat. 492 as amended, 42 U.S.C.A. 411(a) (1).

In 1956 Congress had before it proposed amendments to extend the coverage of the Social Security Act. The Senate Report which is No. 2133 reported in the U. S. Code Congressional & Administrative

News, Volume 3, 1956, commencing at page 3877, contains some excellent references to the intent of Congress in connection with this statute. Referring to the general purpose of the Act, the Senate Report at page 3877 states as follows:

> "The old-age and survivors insurance program is designed to provide partial protection against loss of earned income upon the retirement or death of the worker."

At this session the Senate had before it a proposed amendment to include as self-employment income receipts by an owner who had made a crop-lease and thereafter materially participated in its management. In considering this amendment and also that extending the coverage to other persons, including attorneys, the Report stated at page 3878 as follows:

> "Your committee has consistently held the view that the coverage of the program should be as nearly universal as is practicable."

And then at page 3930:

> "Your committee is of the opinion that in any case in which the owner or tenant establishes the fact that he periodically advises or consults with such other individual as to the production of the commodities and also establishes the fact that he periodically inspects the production activities on the land he will have presented strong evidence of the existence of the degree of participation contemplated by the amendment."

The record in our case clearly shows that Mrs. Stark periodically advised and consulted with Dexter Wobig who had a crop-lease for the farm which had been transferred to the corporation She had also periodically inspected the production activities on the land. It will be recalled that she made one trip in the summer of 1956 and was prevented from doing so in 1957 because of her disability. However, at all times she maintained periodical inspections through her relatives whom she contacted by correspondence. (Tr. 54, 56-57, 86, 90, 96, 97. Original File, V. 2, pp. 121, 120, 122, 112, 123 and 124.) It should also be noted in considering the Congressional intent the expressed desire that the program should be as nearly universal as practicable. The law itself specifically provides that an officer of a corporation is an employee. There are no exceptions in the Act such as those which the government attempts to read into this case. 42 U.S.C.A. 410(k) (1).

It is submitted that the recognition of the corporate entity in this case will actually carry out the intent of Congress. The only situation in which it should be disregarded is where some fraud has been practiced. There is no fraud or deceit in the present case. There is no sham. We are here concerned with a valid existing corporation which was set up at a logical time upon the death of claimant's husband and into which she transferred all of the assets of the estate, together with the income producing portion of her separate property. It was done at a time to permit the participation of her son without personal liability on his part.

Mrs. Stark testified that as far as she knew the corporation was not formed to take advantage of the Social Security Act. This may, of course, have been the intent of her son since it was only after discussing the entire matter with him that a corporation was decided upon. If it had not been for Mrs. Stark's illness she could have continued to operate the corporation and receive a salary which would have been considerably in excess of any social security benefits.

The existence of the separate corporate entity is extremely important in modern industry and business and its stability is essential for tax as well as other purposes. The courts have consistently recognized this principle. In *Skarda* v. *The Commissioner of Internal Revenue* (C.A. 10th, 1957), 250 F. (2d) 429, at page 434, the Court stated as follows:

> "Where the purpose for creating the corporation is to gain an advantage under the law of the state of incorporation, relieve the stockholders from personal liability for debts created by the corporation, or serve the creator's personal convenience, so long as that purpose is the equivalent of business activity, or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity."

In another case involving 100% stock ownership by one individual the Court in *Gardner* v. *The Calvert* (C.A. 3rd 1958), 253 F. (2d) 395 cer. den. May 19, 1958, stated at p. 398 as follows:

"It is a well settled rule that a corporation is for most purposes an entity distinct from its individual shareholders . . . and only in exceptional instances may the separate corporate identity be disregarded."

D. Conclusion.

It is respectfully submitted that there is not only no substantial evidence, but no evidence, and no evidence from which a reasonable inference can be drawn, to support the decision of the Secretary which adopts the decision of the Referee and that accordingly the motion for summary judgment by the Appellee should have been denied and the motion for summary judgment by the Appellant should have been granted, and that therefore this Court should make an order reversing the decision of the District Court and directing it to enter a summary judgment in favor of the Appellant.

Dated at Oakland, California, this 22nd day of June, 1960.

Respectfully submitted,

J. Warren Manuel,
Attorney for Appellant.

APPENDIX

APPENDIX

APPENDIX A

TRANSCRIPT REFERENCES TO MRS. STARK'S DUTIES

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